The 2008 financial crisis gave urgency to the multilateral effort to create a safer and stronger global financial system. Since then, policymakers have largely succeeded in the task of ensuring that the biggest international banks are more resilient to adverse shocks, reducing the risk of another financial crisis as severe as the last one. But policymakers face a new challenge: resisting pressure to roll back reforms.

Now that the postcrisis system is in the final stretch of implementation, policymakers are starting to evaluate possible unintended consequences of the reforms. The key focus will be to ensure that the significant increase in capital and liquidity of major banks around the world will not be undermined. If international regulatory standards can be adapted to apply across a wide range of banks and banking systems, it will also help get greater traction and support for the reforms.

Enhanced regulatory standards have made large international banks more resilient by requiring them to have more loss-absorbing capacity—more capital—and more cash-like assets to meet financial obligations—more liquidity. Banks are also subject to more intense supervision, required to be well prepared to manage risks to their well-being (such as a recession), and expected to have high-quality corporate governance.

If they do get into trouble, there are now international agreements on how they should be restructured or closed (resolved, in regulatory parlance) and who should bear the losses of their failure and in what manner. Progress is also being made in agreeing on how to deal with risks to the broader financial system, such as those posed by so-called shadow banks, which are not regulated like banks but engage in many bank-like activities, such as gathering funds and making loans.

**Taking stock**

Market participants and policymakers have noted some possibly unintended consequences of the new, enhanced regulatory framework. These include:

- Changes in the structure of the financial sector, with some banks choosing to reduce their international activities.
- Shifts in the types of activities that banks are engaged in, with some focusing on retail banking rather than wholesale financing.
- Increased costs for banking services, as banks absorb the costs of enhanced regulatory requirements.
- Potential for increased reliance on alternative financial intermediaries, such as non-bank credit providers.

International financial regulators help ensure the safety and soundness of diverse financial systems

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**Safe and Sound**

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postcrisis regulations. In response, several multilateral organizations are evaluating the economic impact of financial reforms. In most cases, the benefits far outweigh the costs. However, in some cases, some readjustments to regulatory reforms might lower the costs without reducing the benefits. Among the institutions that are evaluating the impact of the reforms is the Financial Stability Board (FSB), which monitors the global financial system and makes recommendations about measures to maintain its stability. The FSB includes finance ministries and central banks from about 25 countries and international financial institutions such as the Bank for International Settlements, the IMF, and the World Bank.

The bodies that promote international cooperation and develop standards in financial regulation—such as the FSB and the Basel Committee for Banking Supervision, which is made up of bank regulators—must also concern themselves with the universal applicability of the standards they set. These standards come in various forms—minimum standards, guidance, principles, codes and good practices, to name a few. Members of both groups represent economies—mostly advanced and some emerging—where banks are important but often only part of a complex financial system. But the guidance on banking supervision and regulation that the FSB and the Basel Committee produce is equally relevant for the many emerging market and developing countries whose economies are largely bank based.

**Global relevance**

The Basel bank supervisory and regulatory standards were initially designed for internationally active banks and were aimed at establishing a level playing field by setting minimum standards for each member country. These standards reflected the best practices in then-member jurisdictions and sought to provide a degree of assurance about the effectiveness of national supervisory regimes and the soundness of national banking systems.

Following the financial crisis, the standards have focused especially on institutions deemed important to the global system and whose failure could have disruptive effects in many countries. Much of the postcrisis reform agenda has been aimed at reducing the likelihood of failure of such systemically important institutions and minimizing losses to taxpayers if they do fail. An important part of these efforts has been enhanced cooperation among national supervisory authorities to help coordinate action in both normal times and crises.

Because most of the world’s countries are not represented in the discussions on the design of these standards, some policymakers and others question the global relevance of the benchmarks. Moreover, because they focus on internationally active and systemically important institutions, their suitability for less sophisticated financial systems, or even for less systemic institutions in the more advanced economies, has been questioned. This critique has led to vigorous discussions about the need for proportionality in the application of financial regulation—that is, the need to ensure that the standards are suitable to the financial system and/or the financial institution.

**Following the financial crisis, the standards have focused on institutions deemed important to the global system.**

The standard setters have made several efforts to enhance the global relevance and acceptance of these norms at all levels of supervision and regulation.

First, to incorporate a range of experience in their work, both the FSB and the Basel Committee expanded their membership following the crisis to include several emerging market economies. They also invite representatives of regional groupings of supervisors to their meetings. The Basel Committee (named for the Swiss city in which it is based) is making greater use of a consultative group of supervisors from nonmember countries, regional and thematic groups, and international organizations with broader membership (such as the IMF) as a sounding board for some of its initiatives.

Second, some of the key standards provide a menu of approaches that range in complexity, allowing countries to select the one to apply to their banks or groups of banks. The best example of this is the standard known as Basel II, which prescribes the minimum amount of capital. The level of capital is based on the amount of risk a bank faces. The Basel II standard offers four approaches for credit risk capital—simplified, standardized, foundation, and advanced. It offers three approaches for operational risk and two for market risk. This standard is based on the philosophy that simpler systems and institutions could move to more complex approaches as their operations evolve. In addition, several elements
in Basel II allow countries to choose either to be exempted from the standard or use a simpler method.

**Core principles**

Third, around the time of the Asian financial crisis, which began in 1997, the Basel Core Principles for Effective Banking Supervision were developed as a global standard for prudential regulation and supervision of banks. The international financial community endorsed them during the annual meeting of the IMF and World Bank in October of that year. The principles, which have been revised twice, lay out expectations based on internationally accepted good practices and minimum standards. They cover a range of interrelated topics, including requirements for the entry, exit, and operations of banks; the powers, responsibilities, independence, and accountability of supervisors; and guidance on prudential standards and for managing the various types of risks banks face. These principles are designed to apply to a range of jurisdictions and are a key component of the assessments carried out by the IMF and the World Bank when they periodically review countries' financial sectors.

Fourth, efforts have been made to adapt Basel guidance to so-called microfinance institutions that specialize in making small loans to underserved people. This is part of a broader effort at financial inclusion—bringing into the financial system people and firms that have not had access to financial services, including banking.

Finally, there have also been serious attempts in recent years to simplify the regulatory framework, based on the experience born of the crisis that complex rules were hard to implement and supervise. This simplification would have contributed to more universal application but would have come with a loss of risk sensitivity. This trade-off, and of course the complex nature of some financial activities, makes a one-size-fits-all approach difficult to achieve.

Despite the efforts to make standards relevant to diverse institutions and financial systems, national supervisors, especially those dealing with less complex systems, yearn to make sense of the constant introduction of new standards and revisions of older ones. The increased focus on systemically important institutions since the global crisis has magnified those concerns. Banks not deemed to be systemic worry that some of these regulations are cascading down to them, even though the regulations are not always suited to the simpler size and plain-vanilla business models of smaller institutions. This has led to calls to implement key regulations in a manner proportionate to the risks posed by nonsystemic banks, but there has not been any internationally agreed approach on how to do this.

In some jurisdictions, such as the United States, supervisors have crafted tiered regimes that use asset size and complexity to determine the rigor of both supervisory and regulatory approaches. Further proposals under discussion aim to lower the regulatory burden on community banks in the United States. This issue of proportionality is also under discussion in Europe, where smaller savings and regional banks complain about the excessive compliance costs they incur in reporting under these regimes—both to supervisors and to the public—even though they are not systemic institutions. At the same time, supervisors on both continents are treading carefully, realizing that even difficulties in small institutions can collectively lead to systemic problems. That is what happened in the savings and loans crisis in the United States in the 1980s. Some supervisors also worry that with their resources now focused on systemically important banks, they may be unable to monitor smaller firms as well as they did in the past.

**Proportionality**

The issue of proportionality is also playing out across countries. On the one hand, developing economies with less complex financial systems would like to view some of these standards as aspirational—that is, ones that their financial system could eventually meet. Proportionality makes a one-size-fits-all approach difficult to achieve. On this count, they would like to better tailor the standards to be relevant to their national situation. On the other hand, officials in developing economies worry that if they do not meet the standards as
written, investors might incorrectly take a dim view of the soundness of their institutions—which would increase the cost of access to international markets. Toward this end, officials in developing economies seek advice on identifying the standards and good practices relevant to them to provide greater assurance of financial stability. They also want to know how to prioritize implementation in keeping with limits on their resources. These officials seek to develop a strategy, path, and timeline to help them fully implement the standards as their financial systems increase in complexity and sophistication.

Here, the IMF plays an important role by providing technical assistance on financial sector stability and market development to more than 100 countries every year through both long-term resident advisors and short-term expert visits. Nearly half of the assistance in financial sector areas focuses on strengthening banking supervision and regulation—by helping countries adopt good practices and international standards that are applicable, and at times by adapting them to local conditions. The IMF, together with the World Bank, also helps countries with legislative and institutional reforms, safety nets, accounting and auditing, and corporate governance frameworks to help prepare them to implement more complex standards.

With postcrisis regulatory reforms largely completed, providing greater clarity on the issue of their proportionate application across banks that are not systemically important should now find a place on the agenda of standard-setting bodies and international forums. Providing this clarity will add to the universal appeal of the reforms and reduce calls for their rollback. This effort, together with providing good guidance to emerging market and developing economies on how to identify and implement standards and practices best suited to their national context, requires the active interest and involvement of the global community.

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